# Testimony



## Chairman Ben S. Bernanke

***Outlook of the U.S. economy***

**Before the Joint Economic Committee, U.S. Congress**

**April 27, 2006**

Mr. Chairman and members of the Committee, I am pleased to appear before the Joint Economic Committee to offer my views on the outlook for the U.S. economy and on some of the major economic challenges that the nation faces.

Partly because of last year's devastating hurricanes, and partly because of some temporary or special factors, economic activity decelerated noticeably late last year. The growth of the real gross domestic product (GDP) slowed from an average annual rate of nearly 4 percent over the first three quarters of 2005 to less than 2 percent in the fourth quarter. Since then, however, with some rebound in activity under way in the Gulf Coast region and continuing expansion in most other parts of the country, the national economy appears to have grown briskly. Among the key economic indicators, growth in nonfarm payroll employment picked up in November and December, and job gains averaged about 200,000 per month between January and March. Consumer spending and business investment, as inferred from data on motor vehicle sales, retail sales, and shipments of capital goods, are also on track to post sizable first-quarter increases. In light of these signs of strength, most private-sector forecasters, such as those included in the latest Blue Chip survey, estimate that real GDP grew between 4 and 5 percent at an annual rate in the first quarter.

If we smooth through the recent quarter-to-quarter variations, we see that the pace of economic growth has been strong for the past three years, averaging nearly 4 percent at an annual rate since the middle of 2003. Much of this growth can be attributed to a substantial expansion in the productive capacity of the U.S. economy, which in turn is largely the result of impressive gains in productivity--that is, in output per hour worked. However, a portion of the recent growth reflects the taking up of economic slack that had developed during the period of economic weakness earlier in the decade. Over the past year, for example, the unemployment rate has fallen nearly 1/2 percentage point, the number of people working part time for economic reasons has declined to its lowest level since August 2001, and the rate of capacity utilization in the industrial sector has moved up 1-1/2 percentage points. As the utilization rates of labor and capital approach their maximum sustainable levels, continued growth in output--if it is to be sustainable and non-inflationary--should be at a rate consistent with the growth in the productive capacity of the economy. Admittedly, determining the rates of capital and labor utilization consistent with stable long-term growth is fraught with difficulty, not least because they tend to vary with economic circumstances. Nevertheless, to allow the expansion to continue in a healthy fashion and to avoid the risk of higher inflation, policymakers must do their best to help to ensure that the aggregate demand for goods and services does not persistently exceed the economy's underlying productive capacity.

Based on the information in hand, it seems reasonable to expect that economic growth will moderate toward a more sustainable pace as the year progresses. In particular, one sector that is showing signs of softening is the residential housing market. Both new and existing home sales have dropped back, on net, from their peaks of last summer and early fall. And, while unusually mild weather gave a lift to new housing starts earlier this year, the reading for March points to a slowing in the pace of homebuilding as well. House prices, which have increased rapidly during the past several years, appear to be in the process of decelerating, which will imply slower additions to household wealth and, thereby, less impetus to consumer spending. At this point, the available data on the housing market, together with ongoing support for housing demand from factors such as strong job creation and still-low mortgage rates, suggest that this sector will most likely experience a gradual cooling rather than a sharp slowdown. However, significant uncertainty attends the outlook for housing, and the risk exists that a slowdown more pronounced than we currently expect could prove a drag on growth this year and next. The Federal Reserve will continue to monitor housing markets closely.

More broadly, the prospects for maintaining economic growth at a solid pace in the period ahead appear good, although growth rates may well vary quarter to quarter as the economy downshifts from the first-quarter spurt. Productivity growth, job creation, and capital spending are all strong, and continued expansion in the economies of our trading partners seems likely to boost our export sector. That said, energy prices remain a concern: The nominal price of crude oil has risen recently to new highs, and gasoline prices are also up sharply. Rising energy prices pose risks to both economic activity and inflation. If energy prices stabilize this year, even at a high level, their adverse effects on both growth and inflation should diminish somewhat over time. However, as the world has little spare oil production capacity, periodic spikes in oil prices remain a possibility.

The outlook for inflation is reasonably favorable but carries some risks. Increases in energy prices have pushed up overall consumer price inflation over the past year or so. However, inflation in core price indexes, which in the past has been a better indicator of longer-term inflation trends, has remained roughly stable over the past year. Among the factors restraining core inflation are ongoing gains in productivity, which have helped to hold unit labor costs in check, and strong domestic and international competition in product markets, which have restrained the ability of firms to pass cost increases on to consumers. The stability of core inflation is also enhanced by the fact that long-term inflation expectations--as measured by surveys and by comparing yields on nominal and indexed Treasury securities--appear to remain well-anchored. Of course, inflation expectations will remain low only so long as the Federal Reserve demonstrates its commitment to price stability. As to inflation risks, I have already noted that continuing growth in aggregate demand in excess of increases in the economy's underlying productive capacity would likely lead to increased inflationary pressures. In addition, although pass-through from energy and commodity price increases to core inflation has thus far been limited, the risk exists that strengthening demand for final products could allow firms to pass on a greater portion of their cost increases in the future.

With regard to monetary policy, the Federal Open Market Committee (FOMC) has raised the federal funds rate, in increments of 25 basis points, at each of its past fifteen meetings, bringing its current level to 4.75 percent. This sequence of rate increases was necessary to remove the unusual monetary accommodation put in place in response to the soft economic conditions earlier in this decade. Future policy actions will be increasingly dependent on the evolution of the economic outlook, as reflected in the incoming data. Specifically, policy will respond to arriving information that affects the Committee's assessment of the medium-term risks to its objectives of price stability and maximum sustainable employment. Focusing on the medium-term forecast horizon is necessary because of the lags with which monetary policy affects the economy.

In the statement issued after its March meeting, the FOMC noted that economic growth had rebounded strongly in the first quarter but appeared likely to moderate to a more sustainable pace. It further noted that a number of factors have contributed to the stability in core inflation. However, the Committee also viewed the possibility that core inflation might rise as a risk to the achievement of its mandated objectives, and it judged that some further policy firming may be needed to keep the risks to the attainment of both sustainable economic growth and price stability roughly in balance. In my view, data arriving since the meeting have not materially changed that assessment of the risks. To support continued healthy growth of the economy, vigilance in regard to inflation is essential.

The FOMC will continue to monitor the incoming data closely to assess the prospects for both growth and inflation. In particular, even if in the Committee's judgment the risks to its objectives are not entirely balanced, at some point in the future the Committee may decide to take no action at one or more meetings in the interest of allowing more time to receive information relevant to the outlook. Of course, a decision to take no action at a particular meeting does not preclude actions at subsequent meetings, and the Committee will not hesitate to act when it determines that doing so is needed to foster the achievement of the Federal Reserve's mandated objectives.

Although recent economic developments have been positive, the nation still faces some significant longer-term economic challenges. One such challenge is putting the federal budget on a trajectory that will be sustainable as our society ages. Under current law, federal spending for retirement and health programs will grow substantially in coming decades--both as a share of overall federal spending and relative to the size of the economy--especially if health costs continue to climb rapidly. Slower growth of the workforce may also reduce growth in economic activity and thus in tax revenues.

The broad dimensions of the problem are well-known. In fiscal year 2005, federal outlays for Social Security, Medicare, and Medicaid totaled about 8 percent of GDP. According to the projections of the Congressional Budget Office (CBO), by the year 2020 that share will increase by more than three percentage points of GDP, an amount about equal in size to the current federal deficit. By 2040, according to the CBO, the share of GDP devoted to those three programs (excluding contributions by the states) will double from current levels, to about 16 percent of GDP. Were these projections to materialize, the Congress would find itself in the position of having to eliminate essentially all other non-interest spending, raising federal taxes to levels well above their long-term average of about 18 percent of GDP, or choosing some combination of the two. Absent such actions, we would see widening and eventually unsustainable budget deficits, which would impede capital accumulation, slow economic growth, threaten financial stability, and put a heavy burden of debt on our children and grandchildren.

The resolution of the nation's long-run fiscal challenge will require hard choices. Fundamentally, the decision confronting the Congress and the American people is how large a share of the nation's economic resources should be devoted to federal government programs, including transfer programs like Social Security, Medicare, and Medicaid. In making that decision, the full range of benefits and costs associated with each program should be taken into account. Crucially, however, whatever size of government is chosen, tax rates will ultimately have to be set at a level sufficient to achieve a reasonable balance of spending and revenues in the long run. Members of the Congress who want to extend tax cuts and keep tax rates low must accept that low rates will be sustainable over time only if outlays can be held down sufficiently to avoid large deficits. Likewise, members who favor a more expansive role of the government must balance the benefits of government programs with the burden imposed by the additional taxes needed to pay for them, a burden that includes not only the resources transferred from the private sector but also the reductions in the efficiency and growth potential of the economy associated with higher tax rates.

Another important challenge is the large and widening deficit in the U.S. current account. This deficit has increased from a little more than $100 billion in 1995 to roughly $800 billion last year, or 6-1/2 percent of nominal GDP. The causes of this deficit are complex and include both domestic and international factors. Fundamentally, the current account deficit reflects the fact that capital investment in the United States, including residential construction, substantially exceeds U.S. national saving. The opposite situation exists abroad, in that the saving of our trading partners exceeds their own capital investment. The excess of domestic investment over domestic saving in the United States, which by definition is the same as the current account deficit, must be financed by net inflows of funds from investors abroad. To date, the United States has had little difficulty in financing its current account deficit, as foreign savers have found U.S. investments attractive and foreign official institutions have added to their stocks of dollar-denominated international reserves. However, the cumulative effect of years of current account deficits have caused the United States to switch from being an international creditor to an international debtor, with a net foreign debt position of more than $3 trillion, roughly 25 percent of a year's GDP. This trend cannot continue forever, as it would imply an ever-growing interest burden owed to foreign creditors. Moreover, as foreign holdings of U.S. assets increase, at some point foreigners may become less willing to add these assets to their portfolios. While it is likely that current account imbalances will be resolved gradually over time, there is a small risk of a sudden shift in sentiment that could lead to disruptive changes in the value of the dollar and in other asset prices.

Actions both here and abroad would contribute to a gradual reduction in the U.S. current account deficit and in its mirror image, the current account surpluses of our trading partners. To reduce its dependence on foreign capital, the United States should take action to increase its national saving rate. The most direct way to accomplish this objective would be by putting federal government finances on a more sustainable path. Our trading partners can help to mitigate the global imbalance by relying less on exports as a source of growth, and instead boosting domestic spending relative to their production. In this regard, some policymakers in developing Asia, including China, appear to have recognized the importance of giving domestic demand a greater role in their development strategies and are seeking to increase domestic spending through fiscal measures, financial reforms, and other initiatives. Such actions should be encouraged. For these countries, allowing greater flexibility in exchange rates would be an important additional step toward helping to restore greater balance both in global capital flows and in their own economies. Structural reforms to enhance growth in our industrial trading partners could also be helpful. Each of these actions would be in the long-term interests of the countries involved, regardless of their effects on external imbalances. On the other hand, raising barriers to trade or flows of capital is not a constructive approach for addressing the current account deficit because such barriers would have significant deleterious effects on both the U.S. and global economies.

In conclusion, Mr. Chairman, the economy has been performing well and the near-term prospects look good, although as always there are risks to the outlook. Monetary policy will continue to pursue its objectives of helping the economy to grow at a strong, sustainable pace while seeking to keep inflation firmly under control. And, while many of the fundamental factors that determine longer-term economic growth appear favorable, actions to move the federal budget toward a more sustainable position would do a great deal to help ensure the future prosperity of our country.

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